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C O N F I D E N T I A L QUITO 000220

SIPDIS

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TAGS: EFIN ECON ETRD EPET EC
SUBJECT: GOE Policy for a Vulnerable Economy: Buying Time and Hoping Oil Prices Rise

A) Quito 188, B) Quito 60, C) 08 Quito 1145, D) 08 Quito 1124, E) 08 Quito 1062, F) 08 Quito 831

Classified by Ambassador Heather Hodges. Reason: 1.4 b and d.

¶1. (C) Summary. The Ecuadorian economy, which is dollarized and heavily dependent on oil exports, is under considerable stress because of falling oil prices and the global economic crisis. Oil prices have risen in March, providing some relief. If oil prices remain at current levels or rise, the economy might muddle through ¶2009. However, there is a substantial risk, particularly if oil prices fall again, that Ecuador could experience a bank, fiscal or balance of payments crisis. If so, Ecuador might be forced off the dollar.

¶2. (C) Summary, continued. Ecuador accentuated the current problems by overspending in 2007/2008, depleting almost all its income from the high oil prices and increasing demand for imports. It has weathered the pressure thus far by drawing on government reserves (down to $3.5 billion, from $6.5 billion in September) and the banks' privately held offshore funds (also around $3.5 billion, down from roughly $4.5 billion in January). The economy is adjusting to a degree, with government-imposed trade restrictions and moderate fiscal discipline, while private demand has fallen and banks have curtailed lending. However, the government, which is facing elections on April 26, has avoided deep budget cuts and is gambling on higher oil prices and multilateral financing. The gamble might pay off, but a failure to take more rigorous actions now might backfire if oil prices decline or sufficient financing is not available. End summary.

Signs of Stress

¶3. (C) The Ecuadorian economy is clearly under stress as a result of the global economic crisis, a situation that has been complicated by existing policies such as dollarization (adopted in 2000) as well as more recent decisions, particularly high levels of government spending in 2007 and 2008, when oil prices were high. This high level of spending sustained economic growth for two years when private sector investment was low, but also created government spending patterns and an overall demand for imports that are not sustainable at current petroleum prices.

¶4. (C) As noted in reftel d, by November, the government began to perceive that global economic problems, in the form of falling oil prices, remittances, and non-petroleum exports, would create problems for Ecuador. The absence of a floating exchange rate (because of dollarization) and a meaningful local stock market meant that some of the early indicators of stress were not functioning in Ecuador for most of 2008. By December, however, the government had begun to release a number of indicators that demonstrated that the economy was under considerable pressure. These indicators included:

-- The average price for Ecuadorian petroleum exports fell from $119/barrel in June to $26/barrel in December.

-- The monthly trade balance turned negative starting in September; Ecuador has had five consecutive months with a trade deficit.

-- Remittances fell 9% in 2008 compared to 2007, and 4th quarter 2008 remittances fell 22% compared to the same period in 2007.

-- Central Bank reserves fell from a peak of $6.5 billion in September to $4.5 billion in December, with a $1.5 billion drop in December alone. Reserves continued to slip in 2009, dropping to $3.4 billion on March 20.

-- The central government's net petroleum income (subtracting petroleum investment and subsidies) has dropped sharply; monthly net petroleum income peaked at $880 million in the third quarter for 2008, dropped to $96 million in December, and was approximately $42 million in January and February.

-- Deposits in private banks fell in mid-December before partially recovering following December 31st deposits by the government. Deposits continued to fall through February and were down $694 million between December 31 and February 20.

Eight Key Factors

¶5. (SBU) This cable discusses eight intermingled factors that are key to determining whether the Ecuadorian economy will muddle through

2009 or enter into a crisis: petroleum prices, dollarization, reserves, public sector budget, balance of payments, the banking sector, economic production, and external financing.

Petroleum Price

¶6. (C) Given the imbalances created by the government's spending spree in 2007 and 2008, the economy was under severe pressure with a price for Ecuadorian crude under $30/barrel, as was the case in December and January. However, in March the international reference price for petroleum began to climb, with WTI trading slightly over $50/barrel by March 23. Also important for Ecuador was that the discount for its lower-grade petroleum began to shrink (the discount was $15/barrel in December/January, but according to anecdotal reporting it dropped to $5-8/barrel in March).

¶7. (C) Prospects/implications: Although it is not a given that prices will remain at current levels, oil at $40-45/barrel gives the Ecuadorian economy considerably more breathing room than it had in December-February. After the high level of government expenditures and imports in 2008, the economy will still be under pressure at this price level. However, at $40-45/barrel, the government will have more time to adjust expenditures, seek financing, and hope that oil prices will climb further. In the long-run, Ecuador would be wise to lower its dependence on oil revenues, but it has not shown that it is prepared to do so. The government is eyeing mining as the next big revenue earner, and if that sector were to emerge Ecuador would still remain dependent on natural resource prices.

Dollarization

¶8. (SBU) As government officials have noted, dollarization limits Ecuador's ability to respond to international pressures since it cannot depreciate its currency. Although not publicly mentioned, dollarization also prevents the government from engaging in open-ended borrowing from the Central Bank. Another factor that is widely acknowledged but rarely emphasized publicly is that there is no lender of last resort for the banking sector in the case of a liquidity squeeze or bank run.

¶9. (SBU) For all its limitations, however, dollarization is highly popular in Ecuador. The stability brought by dollarization is seen as the underlying factor in Ecuador's solid economic growth and low inflation since the dollar was adopted as the national currency in

¶2000. Some exporters bemoan the reduced competitiveness since the dollar has appreciated against most other currencies in 2008, but other business contacts stress the importance of dollarization in forcing the business sector to focus on costs and efficiency, factors that were more easily hidden in the past with frequent depreciations. Dollarization also forces discipline on public sector finances and private banking operations.

¶10. (C) One former Minister of Finance says that most Ecuadorians measure the current economic problem with one question -- will Ecuador maintain dollarization? -- without questioning the broader policy environment that supports dollarization. She maintains that as long as they believe dollarization will continue, most Ecuadorians will leave their funds in the local banking system, but will immediately withdraw the funds if they believe that dollarization will end.

¶11. (C) While President Correa seems philosophically opposed to dollarization, he has repeatedly asserted that his government does not intend to abandon the dollar in the near future (leaving the question open for further down the road). His government has justified its adjustment measures -- trade barriers and expenditure reductions -- as necessary to protect dollarization. Most economic analysts believe that the Correa Administration will defend dollarization in the near future, recognizing that ending dollarization could lead to a bank run and carry heavy economic and political costs. However, in March Central Bank staff were reportedly working on a regulation, which was quietly circulated by the business community, that would allow the operation of a parallel currency. Also, in March rumors circulated that the government had printed a new currency called the "Condor," a rumor vehemently denied by Correa.

¶12. (C) Prospects/implications: Even if Correa dislikes dollarization and would prefer the policy flexibility and "sovereignty" of a new currency, it is very hard to see how the government could successfully introduce a new currency when the economy is under considerable strain. The populace would have little

confidence in the new currency, which would likely quickly depreciate if it were allowed to float. This would reduce the value of wages and financial assets and lead to popular discontent. We cannot rule out an effort to replace the dollar voluntarily but consider it unlikely in the near future. The two more likely scenarios are that the government is forced to issue a parallel currency because of insufficient revenues (see fiscal section) or a bank run that leads to the collapse of the banking sector (see banking section). These two scenarios, particularly the banking collapse, are severe and would carry high political and economic costs.

International Reserves

¶13. (SBU) The Central Bank's reserves play a rather different role in a dollarized economy than one with its own currency. Typically, the reserves are available to provide balance of payments support in case of a shortfall in the current or capital account. In Ecuador, however, private sector funds (for trade, investment, or loans) are channeled through the private banks, which for the most part do not have recourse to Central Bank reserves. To the extent that there is a shortfall in liquidity for the private banks, they need to draw down their individually held offshore liquidity funds, which reportedly totaled around $3.7 billion in early March and are separate from the Central Bank's reserves.

¶14. (SBU) In Ecuador, Central Bank reserves are better seen as the government's savings account. The main source of funds in the reserves is public sector deposits, and reserves rise when the public sector saves and drops when it pulls down its savings. In December, the $1.5 billion drop in reserves was largely explained by a $2.1 billion withdrawal from Central Government deposits, which was only partially offset by tax and petroleum deposits.

¶15. (SBU) While most funding for the reserves is from the public sector, private banks also deposit a limited portion of their funds in the Central Bank, either as mandated by the required reserve provisions or for short-term operational needs (one bank said that about 5% of its assets are in the Central Bank, more than the

required reserve). In January, the largest contributor to the drop in Central Bank reserves was the withdrawals by the banking sector, which in turn was prompted by a fall in deposits in the banking sector.

¶16. (C) Prospects/implications: Ecuador entered the last quarter of 2008, when the crisis began to manifest itself in Ecuador, with decent buffers, particularly if one counts the banks' privately held liquidity funds in addition to the Central Bank's reserves. The government has quickly run through much of its reserves, particularly in December when it not only spent freely on domestic spending but also allegedly spent several hundred million dollars on repurchasing international bonds at a large discount. There is still some cushion left, which allows the government to operate in the first quarter of 2009 even though it is spending more than it earns, and for the banks to absorb a fall in deposits and remain liquid. However, the government and banks both need to be careful not to reduce their cushions to the point that the general public begins to believe that the institutions and dollarization are at risk. It is worth noting that the Central Bank's reserves are published weekly and are now closely watched by the media, but the private banks' offshore liquidity funds are not published information.

Public Sector Finances

¶17. (SBU) Public sector expenditure exploded in 2008 with the high price of petroleum, plus access to financing from the petroleum reserves funds, which were dismantled in April 2008, allowing the government to freely spend those funds. Central Government expenditures increased 67% in 2008 over 2007, with sharp increases in both current and capital expenses. Petroleum revenues accounted for 39% of central government revenues in the first three quarters of 2008, but dropped to roughly 8% of government revenues in the first two months of 2009. Taxes, plus the occasional extraordinary income such as telephone concession fees, provide the remaining government income.

¶18. (C) The government has asserted that it will contain expenditures to reduce the government deficit to manageable proportions. It has sent some signals about budget cuts, such as cutting Petroecuador's budget, and we have heard anecdotal stories about reduced transfers to local governments and universities. However, the government has not provided an overall budget estimate for the year or any clear public statement on how it will manage the budget and where it will cut spending. (Note: the GOE is operating on a continuing resolution, and does not need to present a 2009 budget until after the new government takes office following the April 26 elections.)

¶19. (C) The government's message on the extent to which it will pursue fiscal discipline is muddled, which may reflect uncertain policy direction or a desire not to send strong budget-cutting signals before the April 26 elections. For example, Minister for Economic Policy Borja asserted that the poor would not suffer from the adjustment program, that public sector employees would not be fired, and the government would not cut subsidies. He added that the government would continue to implement partially complete infrastructure projects. On the other hand, the government has indicated that it will fire employees at Petroecuador, the state-owned petroleum company, although it evidently has not decided how many. And in March, media stories reported that overall subsidy costs would fall in 2009. Some subsidies, particularly for refined petroleum products, fall automatically with lower petroleum prices, but other subsidies that are projected to fall, such as for housing, evidently reflect policy changes.

¶20. (C) In a March 11 meeting with the Ambassador, Minister Borja said that the government would cut capital expenses to roughly half of 2008 levels and constrain current expenditures through a wage freeze (reftel a). He estimated a government deficit of $2.5 billion in 2009, based on an average price of $35.5/barrel for Ecuadorian crude in 2009 (this was an increase over the levels that prevailed in January/February; the government was assuming that the price of petroleum would rise in the second half of the year).

¶21. (U) A few non-government analysts have provided estimates for

public sector finances for 2009. The Observatory for Fiscal Policy estimated a deficit of $3.8 billion, based on oil at $30/barrel. The financial publication Latin Source estimated a deficit of $2.8 billion dollars, assuming an oil price of $37/barrel.

¶22. (C) Prospects/implications: The government is making a moderate effort to contain spending in the expectation that oil prices will rise and external financing will be available. This is a risky bet, but if these assumptions hold, it will have avoided the political and economic costs of a more rigorous budget cut. If these assumptions do not hold, it will have depleted much of its reserves by the second half of 2009. By that time, further budget cuts might not be sufficient, and it may reach the point that it begins to accrue arrears to suppliers and employees, and possibly be forced to issue a parallel "currency" or "promissory notes." If so, diminished reserves and the appearance of a parallel currency would likely sharply reduce public confidence in the sustainability of dollarization, which could provoke a bank run.

Balance of Payments

¶23. (C) Like the budget, Ecuador's balance of payments is highly vulnerable to a decline in oil prices. In addition, Ecuador's two other principal sources of foreign exchange, remittances and non-petroleum exports, have declined in the face of the global economic problems. In recent years, a trade surplus and remittances offset the other parts of the balance of payments, which are usually negative (services, rent, and capital account). With a trade deficit, Ecuador will face a balance of payments gap that will need to be covered with external financing and reserves.

¶24. (SBU) In November, Ecuador raised tariffs on a range of consumer goods to their WTO ceilings. In January, it imposed additional tariffs and quotas that exceeded WTO ceilings, arguing that such measures were necessary because of balance of payments pressure and were consistent with the WTO balance of payments safeguard provisions (ref b). The government estimated that the January measure would reduce the trade deficit by $1.5 billion. A number of business sector contacts and private sector analysts argued that even in the absence of the trade restrictions, there would be a strong element of self-adjustment in the balance of trade because imports would be strongly constrained by weak demand and sharply reduced trade financing.

¶25. (C) The Central Bank, in an unpublished balance of payments projection for 2009, estimates that the current account will have a $1.5 billion deficit, including a $2.5 billion trade deficit (this estimate incorporates the trade measures introduced in January). It estimates a capital account deficit of approximately $750 million. The combined shortfall is about $2.25 billion, and the Central Bank assumes this would be covered with $2 billion in financing from multilateral lenders and a $250 million reduction in reserves. The business publication Latin Source estimates trade and current account deficits that are comparable to the Central Bank's estimate, but does not provide an estimate for the capital account or financing.

¶26. (C) Prospects/implications: As oil prices fell in 2008, the initial point of concern for many analysts was the balance of payments. Those concerns have diminished to an extent because of the trade measures and the expectation of self-adjustment in the balance of trade. Even so, the sound performance of the external sector is critical for smooth functioning of a dollarized economy: the balance of payments needs to generate the dollars needed to maintain the monetary system. A balance of payments deficit would withdraw liquidity from the monetary system, creating problems for banks and public sector finances.

Banking Sector

¶27. (C) The private banking sector in Ecuador is in an awkward situation, since it is relatively well run but vulnerable to a bank run and the probable linchpin in a crisis. On the positive side, the banks are highly liquid (roughly $3.7 billion in liquid off-shore investments -- over 30% of deposits -- that can be used to cover bank run or decline in domestic liquidity), are adequately capitalized at 13% of assets, and have a relatively low default rate.

¶28. (C) Even so, public confidence in the banking system is fragile, and there have been at least three bank runs in the past two years based on fears of bank "holidays" (forced closure) or dedollarization, the most recent in December 2008 when banks lost roughly $300 million in deposits. The public is highly sensitive to such rumors because of massive bank failures in 1999, when many clients lost most or all of their savings.

¶29. (C) As noted in paragraph 3, bank deposits have fallen since the beginning of the year. Bank contacts maintain that while there had been a run in December, the contraction in deposits since December is transaction based. In other words, with a decline in dollar income, liquidity in the Ecuadorian system has dropped and so have deposits, but meanwhile clients have continued to withdraw dollars to fulfill business obligations. Banks have partially funded this shortfall by drawing on their offshore liquidity funds (which had been around $4.5 billion at the beginning of the year). Banks have also sharply curtailed lending in order to preserve their liquidity.

¶30. (C) The government appears to be aware of the challenges to the banking sector. After taking a largely antagonistic approach towards the banks for his first two years in office, in February President Correa met bank leaders for the first time since becoming president. The move was partly political, to demonstrate cooperation between the government and the banks to reinforce public confidence. However, it also led to several measures to help the banks. One was a promise to consider increasing interest rates, which the government forced down in 2008 (reftel f). Another was a decision to lower the required reserve rate from 4% to 2%; the released 2%, however, was transferred immediately to a new government-established liquidity fund (in the absence of such a measure, banks would have had to curtail lending or dip into their privately-held liquidity funds to make the required contributions to the new government-run liquidity fund). The Ecuadorian Social Security Institute will also purchase up to $400 million in newly issued bank mortgages, in an effort to promote additional lending.

¶31. (C) Prospects/implications: The banking sector is vulnerable to a bank run in two ways. One is a general panic about the prospect of dedollarization, which would likely come as a result of a pronounced deterioration of public sector finances and/or a sharp drop in liquidity because of balance of payments pressure. If this were to happen, the corporate sector and the wealthy would try to transfer abroad the limited financial resources they still have in Ecuador (most have steadily reduced their financial exposure in Ecuador over the years), while those without access to international financial institutions would withdraw their bank holding in cash (many have transferred term deposits to sight deposits in preparation for a rapid withdrawal). A second risk is that a few small banks might fail. Some are under pressure after the government lowered interest rates and reduced most banking fees, and most do not have the sizeable liquidity funds that the large banks have. The banking system -- and public sector confidence -- might absorb the closure of 1-2 small banks, but if several failed that could undermine confidence in the entire banking sector.

¶32. (C) Prospects/implications, continued: Under either scenario, a major bank run could force the temporary shut-down of the banking sector. That in turn is the most likely scenario to force Ecuador off the dollar. A combination of bank closures and dedollarization would be a major crisis and would likely lead to a sharp economic contraction. Given the weak economic institutions in Ecuador, particularly a Central Bank that lacks strong leadership and has lost some of its qualified staff, it could be difficult for Ecuador to emerge quickly from a bank holiday/dedollarization.

Real Economy

¶33. (C) The Central Bank estimates that the Ecuadorian economy grew 5.3% in 2008 (likely an overestimation based on optimistic assumptions about the government's spending on infrastructure). Even allowing for some overestimation, the economy grew at a strong rate last year, which on first reflection is surprising because of the poor investment climate and modest private sector investment. Growth was sustained by heavy government spending, and, to lesser extent,

increased bank lending. This supported strong consumer demand, which created a good year for companies that catered to domestic demand.

¶34. (C) Growth in 2009 will be significantly lower. The poor investment climate remains. In addition, lower government spending, remittances (an important source of consumer demand), non-petroleum exports (which are labor intensive), and lending will constrain economic growth. Some of our business contacts told us that demand held up fairly well through January (in some instances because of advance purchases in anticipation of price increases due to trade restrictions), but that demand sharply contracted in February. Media reports suggest that construction (an important employer of the urban poor) may already be contracting. Economic Minister Borja said that growth would be 2.3%, the lower end of the government's projections. Some analysts are projecting lower growth than that, or a mild recession.

¶35. (C) Prospects/implications. In the absence of a crisis brought on by a bank run and/or dedollarization, we expect that economic growth will slow appreciably this year, but there would not be a sharp contraction. The government appears intent on implementing only a moderate reduction in spending, in part to avoid the political costs of a sharper cut. If this gamble works, the economy might grow or contract by about 1%. If the government determines after the election that it has to cut spending even further, that would likely push the economy into a deeper recession, although much of that would not be felt until the second half of the year. The positive side of an economic slowdown/contraction is that it will reduce pressure on the balance of payments because of weaker demand for imports. However, a slowdown will further increase unemployment, which began to climb at the end of 2008, and lower tax revenue, which will increase pressure on the fiscal accounts.

Financing

¶36. (C) The GOE expects to finance Ecuador's fiscal and balance of payments gaps primarily with financing from multilateral lenders, namely the InterAmerican Development Bank (IDB), Andean Development Corporation (CAF), and the Latin American Reserve Fund (FLAR). Economic Minister Borja has said publicly that the GOE expects roughly $500 million from each institution. He has said privately that the government also expects to borrow $1 billion from the Ecuadorian Social Security Institute (IESS).

¶37. (C) The Central Bank maintains that Ecuador can cover its balance of payments gap with the $1.5 billion in multilateral lending mentioned above, plus another $500 million from "ongoing" projects from the same institutions, and another $250 million from reserves.

¶38. (C) CAF and IDB representatives in Quito suggest that financing from their institutions will be less than the GOE asserts. The CAF representative said that his bank might be able to lend $300-350 million in net new funds to Ecuador, but stressed that CAF funds are tied to projects and if the GOE curtails investment spending CAF financing might not reach those levels. He added that the GOE asked if the CAF could step in to fund projects that the GOE had already initiated by itself. However, the CAF cannot since it only funds projects where the implementer has been picked through open tenders, and all of the GOE's major investment projects had been allocated through sole-source tenders.

¶39. (C) The IDB representative said that the GOE has asked for a $100 million competitiveness project (which essentially would be budget support) and a $500 million liquidity facility, which would go

to a government development bank, and from there lent to private banks, which would use the funds to support private sector trade. He acknowledged that both projects would require an assessment letter from the IMF, which he thought might be available in April (the GOE is providing information on its adjustment efforts to the IDB and IMF through document exchanges and video conferences). He speculated that the liquidity facility, if it went forward, would be appreciably less than the GOE was requesting (perhaps $100-200 million), in part because of constraints on overall IDB financing. He added that if the GOE worked really hard to implement ongoing health and education projects, the IDB might be able to disburse $100-150 million under those projects.

¶40. (C) The Embassy does not have contact with the FLAR (a regional IMF-like institution), since it does not have an office in Quito. The government maintains that it will borrow $480 million from the FLAR. One former Ministry of Finance official said that FLAR prides itself on IMF-like criteria to determine economic sustainability, and while less rigorous than the IMF it was not a given that the FLAR would extend financing to Ecuador.

¶41. (C) Several private sector analysts argue that Ecuador is solvent, and, with government external debt at 19.6% of GDP, in good position to take on additional debt to get it through the current crisis and keep dollarization intact. Those same contacts speculated that the government might approach the IMF for a Stand-by Arrangement after the April 26 election, arguing that it is the best placed institution to support Ecuador in the current crisis.

¶42. (C) Ecuador has defaulted on two of its principal commercial bond issuances, the Global 2012 and Global 2015, alleging that the issuances were illegitimate (reftel c and e). President Correa announced that Ecuador would present a debt restructuring agreement on the margins of the March 27-31 IDB annual meeting in Medellin, Colombia. However, the default, which bond holders see as a political decision, precludes access to commercial lending for the time being. In addition, the default and the status of negotiations between the GOE and the bondholders might be a factor for some of the multilateral lenders, although it does not appear to be an insurmountable obstacle for the IDB, CAF, or FLAR.

¶43. (C) Prospects: Some multilateral financing will be available, but probably not as much as the GOE has indicated, and probably not as quickly as it has implied. If that is the case, and if international oil prices do not continue to rise, Ecuador will have to draw down its international reserves even further. With those prospects, it would make sense for Ecuador to approach the IMF. However, that would require Correa to swallow his animosity towards the IMF, and it is not evident that he would.

Comment

¶44. (C) The Ecuadorian economy is highly vulnerable, having spent most of its oil boom resources and created fiscal and balance of payments pressures that are hard to unwind. The government's trade restrictions and budget cutbacks will buy it some time as the government hopes that oil prices will rise. However, the government is not approaching the crisis as though it has to deal with a worst-case, or even bad-case, scenario. Instead, it is maintaining a relatively high level of expenditure, and most likely spent $200-300 million in badly needed reserves to buy back debt in December. As a result it has quickly depleted its reserves.

¶45. (C) As of late March, it is an open question whether Ecuador will stumble through 2009 without a crisis, or suffer a major crisis that forces Ecuador off the dollar in late 2009 or early 2010. However, this 50/50 perspective is an improvement over apparent prospects in January. At that time most analysts consulted by the Embassy thought it was a foregone conclusion that Ecuador would suffer a severe economic crisis, and the question was whether it would happen in the first or second half of the year. The relatively less pessimistic perspective prevailing in March reflects that the government has made some adjustments and could get some outside financing. This mood shift, which also seems to hold with the business community and the broader public, is important, as least for the short term, since it should reduce capital flight and give the economy more time to adjust. If the pessimistic mood in December/January had continued, capital flight may have reached unsustainable levels, provoking a crisis.

¶46. (C) As of the second half of March, oil prices were recovering, and it appears there is a chance the government could win its gamble, provided oil prices remain at current levels or higher, the GOE

obtains a fair portion of its expected external financing, and it continues to maintain a moderate degree of fiscal restraint. However, none of those assumptions are guaranteed. And even if Ecuador makes it through 2009 without a major crisis, it will deplete much of its reserves and the economy will remain vulnerable in 2010

unless there is a strong recovery in oil prices.

Hodges